

Outside Director Tenure Limit: Expertise-Enhancement versus Entrenchment

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Research Question:

The effect of limiting the **tenure** of outside directors
(removing long-term outside directors) on
firms' market **valuation** and their **voting** behavior

Outside Director Tenure and Board Effectiveness

- **Expertise-enhancement View**

- Longer-tenured directors better understand the firm's business and history, enabling them to fulfill their monitoring and advising tasks better
- Empirical evidence: Liu and Sun (2010), Dou, Sagal, and Zhang (2015), Bonni, Deng, Ferrari, Joh, and Ross (2021)

- **Entrenchment View**

- Seasoned outside directors are more likely to be indifferent to shareholder concerns and exhibit excessive deference to management
- Empirical evidence: Vafeas (2003), Hillman, Shropshire, Certo, Dalton, and Dalton (2011)

Summary of Key Results

- We find evidence in support of the hypothesis that long tenures **entrench** outside directors rather than enhance their **experience**
- The stock market reacts **favorably** to the announcement of the tenure limit rule for firms with long-tenured outside directors (LTODs)
 - The effect is more pronounced in **poorly-governed firms** (stronger entrenchment effect)
- Outside directors **dissent more** frequently against management after the rule change
 - This occurs through (1) the removal of LTODs that previously dissented less, (2) the election of new outside directors (NEOD) who dissent more, and (3) an increase in dissent rates among second-term outside directors

Rule Basics

- Prohibits the reelection of outside directors who have served more than **six years** in the same listed firm (or over **nine years** in total in listed firms within the same business group)
 - Long-tenured outside directors (LTOD)
- In effect, outside directors could only be elected for **two terms** (in the case of outside directors with a three-year term)
- Cannot regain eligibility after a specified **cooling-off period**
- Two **concurrent positions** in a business group are not counted twice
- The length of tenure **before mergers or splits** are also considered

Key Dates

Table 1. Key dates concerning the Commercial Act Enforcement Decree amendment

Among the dates listed below, we conduct event studies on the following three dates: event date 1 (September 5, 2019), event date 2 (January 14, 2020), and event date 3 (2020 AGM dates of treated firms).

Dates	Events
✓ September 5, 2019 (event date 1)	The government declared its intention to enforce a tenure limit for outside directors. It should be noted, though, that this announcement was part of a broader package of corporate governance reform measures.
September 24, 2019	The Ministry of Justice released its initial amendment bill to modify the Commercial Act Enforcement Decree. The advance legislative notice period was scheduled to continue until November 4.
December 16, 2019	Prominent newspapers reported that the government was likely to delay the effective date of the new rule, implying it would be applicable not from the 2020 Annual General Meeting (AGM), but rather from the 2021 AGM.
✓ January 14, 2020 (event date 2)	The Ministry of Justice published the final amendment bill, establishing the effective date of the tenure limit rule to be the date of promulgation, which falls before the 2020 AGM.
January 21, 2020	The State Council passed the amendment bill.
January 29, 2020	The government promulgated the amended Commercial Act Enforcement Decree, which took effect on the date of its promulgation.
✓ The 2020 AGM dates (event date 3)	Firms that have long-tenured outside directors held their AGMs.

Removal of LTODs

Table 2. Long-Tenured Outside Directors (LTODs) and Their Removal

Panel A displays the number of LTODs and their tenure length on the boards of companies listed on the KOSPI or KOSDAQ market as of the 2020 AGM in March. The panel also shows the number of LTODs who were removed by that time. Panel B focuses on LTODs who also serve as audit committee members.

Panel A. Number of LTODs and their removal

		All outside directors	LTODs	Removed LTODs
No. of obs.	No. of firm obs.	1,839	637	326
	No. of outside director obs.	3,669	803	386
Tenure length (in years)	At the focal firm	4.06	9.54	9.04
	Including member firms	4.09	9.61	9.11

Panel B. Number of LTODs who were audit committee members and their removal

		All outside directors who were audit committee members	LTODs who were audit committee members	Removed LTODs who were audit committee members
No. of obs.	No. of firm obs.	506	207	128
	No. of outside director obs.	1,505	308	173
Tenure length (in years)	At the focal firm	3.92	8.81	8.45
	Including member firms	3.99	8.98	8.56

Why weren't they removed immediately?

- The exiting term has **not expired**
 - The rule prevents reelection but doesn't necessitate immediate resignation
 - LTODs with unexpired terms are permitted to serve their remaining tenure
 - In exceptional circumstances, terms have been **extended**
 - **Failure to elect a successor** for the audit committee (Commercial Act permits the predecessor to continue serving on the board until a new successor is elected)
 - Extension of the director's term from two to three years by **amending the corporate charter**
 - **Failure to consider** the length of tenure before company splits
- The removal/extension became certain only at the 2020 AGM (especially so for audit committee members)

Hypotheses on Stock Market Reaction

- **(H1a)** The stock market reacts **positively** to the announcement of the new rule
 - Entrenchment effect of tenure length dominates the expertise-enhancement effect
 - **(H1b)** The stock market reacts more positively in firms where the term of the LTODs **expires** at the 2020 AGM
- **(H2)** The valuation effect in **H1** is smaller in **well-governed firms**
 - In well-governed firms, the expertise-enhancement effect outweighs the entrenchment effect
- **(H3a)** The stock market reacts positively to the departure of LTODs from **audit committees** at the 2020 AGM date
 - Removal of LTODs on audit committees became certain only at the 2020 AGM
 - Entrenchment effect of tenure length dominates the expertise-enhancement effect
 - **(H3b)** The stock market reacts negatively to any extension of the terms of LTODs

Hypotheses on Voting Decisions

- Did the new rule on tenure limitation enhanced the **monitoring role** of outside directors?
- **(H4) LTODs** exhibit fewer instances of dissent or abstention compared to other outside directors
- **(H5)** Newly-elected outside directors (**NEODs**), who replace LTODs, demonstrate a higher frequency of dissent or abstention compared to their LTOD counterparts
- **(H6) Second-term** outside directors display higher dissent or abstention rates than first-term outside directors (Jiang, Wan, and Zhao, 2016)
 - Outside directors are aware of the necessity to align with management for protentional reelection only during their first term of service

Sample Construction

- Of all KOSPI and KOSDAQ listed firms as of **March 2020**, we exclude the following firms
 - Financial firms: already subject to a separate tenure limit rule when the 2020 rule was introduced
 - Utility firms: many of them are state-owned, which could be subject to different governance rules
 - Also exclude companies with impaired capital and companies that do not hold AGM in March
- Of these 1,839 firms, **637 firms** had LTODs by the time of the 2020 AGM in March
- Voting decision analyses sample
 - **Hypothesis 4** (LTODs versus other outside directors): votes cast by the LTODs and other outside directors on the boards of **637 firms** during 2018-2019
 - **Hypothesis 5** (LTODs versus NEODs): votes cast by the LOTDs on the boards of **637 firms** during 2018-2019 and the votes cast by the NEODs on the boards of **310 firms** during 2020-2021
 - **Hypothesis 6** (first versus second-term outside directors): votes cast by the first-or second-term outside directors on the boards of **583 firms** during 2018-2021

Voting Decision Data

- **Hand collected** the data from each year's **AGM Convocation Notices** uploaded on DART
 - **Since 2003**, Korea has mandated public firms to disclose detailed activities of outside directors
 - These include the voting decisions of each individual outside director on all board meeting proposals
- Korea is among the few countries where **individual director-level voting data** are accessible

Determinants of CAR around Event 1

(government plan announcement date)

	CAR[-1, +10]							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
LTOD on Board	1.43** [1.99]				7.35** [2.12]			
× CGI					-2.50* [-1.88]			
LTOD Ratio		1.74** [2.07]				8.32** [2.27]		
× CGI						-3.04* [-1.74]		
Longest Tenure			0.19** [2.16]				0.57** [2.18]	
× CGI							-0.17 [-1.46]	
Expire by AGM				1.40 [1.62]				6.21* [1.75]
× CGI								-2.04 [-1.46]
Expire after AGM				1.46* [1.96]				8.91** [2.35]
× CGI								-3.21** [-2.28]
CGI					2.24 [1.31]	1.95 [1.23]	2.25 [1.31]	2.24 [1.31]
Other Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Constant	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	1,730	1,730	1,730	1,730	804	804	804	804
Adj. R-squared	0.0790	0.0788	0.0802	0.0784	0.1309	0.1251	0.1213	0.1305

If CGI=0, jump by 7.35%
If CGI=5, drop by 5.15%

Determinants of CAR around Event 2

(final bill announcement date)

	CAR[-1, +10]							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
LTOD on Board	1.23*				8.01***			
	[1.71]				[2.73]			
× CGI					-3.00**			
					[-2.35]			
LTOD Ratio		1.43				10.88***		
		[1.53]				[2.67]		
× CGI						-4.91**		
						[-2.27]		
Longest Tenure			0.15*				0.52**	
			[1.83]				[2.50]	
× CGI							-0.21*	
							[-1.79]	
Expire by AGM				1.46				8.79***
				[1.53]				[3.26]
× CGI								-3.07***
								[-3.26]
Expire after AGM				0.99				7.43
				[1.33]				[1.41]
× CGI								-3.20
								[-1.21]
CGI					0.67	0.58	0.60	0.69
					[0.85]	[0.75]	[0.69]	[0.86]
Other controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Constant	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	1,744	1,744	1,744	1,744	811	811	811	811
Adj. R-squared	0.0710	0.0706	0.0711	0.0706	0.1226	0.1272	0.1078	0.1222

If CGI=0, jump by 8.01%
If CGI=5, drop by 6.99%

CAR around Event 3

(removal of long-tenured outside directors)

Panel C: CAR around event 3 (annual general shareholders' meeting dates in March 2020)

	Firms with the removal of LTODs		Firms with no removal of LTODs (C)	Firms with LTODs extending the tenure (D)	Difference-in-means	
	Audit Committee Member (A)	Non-Audit Committee Member (B)			(A) – (C)	(B) – (C)
CAR[-5, +5]	4.74%*** (3.61)	1.77% (1.37)	1.24% (1.34)	-10.61% (-1.46)	3.49%** (2.17)	0.52% (0.33)
CAR[-10, +10]	2.21%* (1.83)	-0.91% (-0.77)	-3.02%*** (-3.16)	-18.04% (-1.70)	5.24%*** (3.39)	2.11% (1.38)
No. of Firms	127	197	303	8		

Determinants of CAR around Event 3

(removal of long-tenured outside directors)

	CAR[-10, +10]			
	(1)	(2)	(3)	(4)
LTOD Removal	1.80** [2.02]		5.65* [1.93]	
× CGI			-1.49 [-1.15]	
LTOD (Audit) Removal		3.16** [2.25]		10.99*** [3.13]
× CGI				-3.43** [-2.51]
LTOD (Non-Audit) Removal		0.51 [0.49]		2.49 [0.63]
× CGI				-0.40 [-0.16]
LTOD Term Extension		-11.94** [-2.08]	-11.90** [-2.09]	
CGI			1.16* [1.77]	1.24* [1.80]
Other Controls	Yes	Yes	Yes	Yes
Constant	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Observations	1,747	1,747	806	806
Adj. R-squared	0.1538	0.1536	0.2255	0.2251

Voting Decisions

(long-tenured versus other outside directors)

Figure 1-1. Average *Dissent* rates

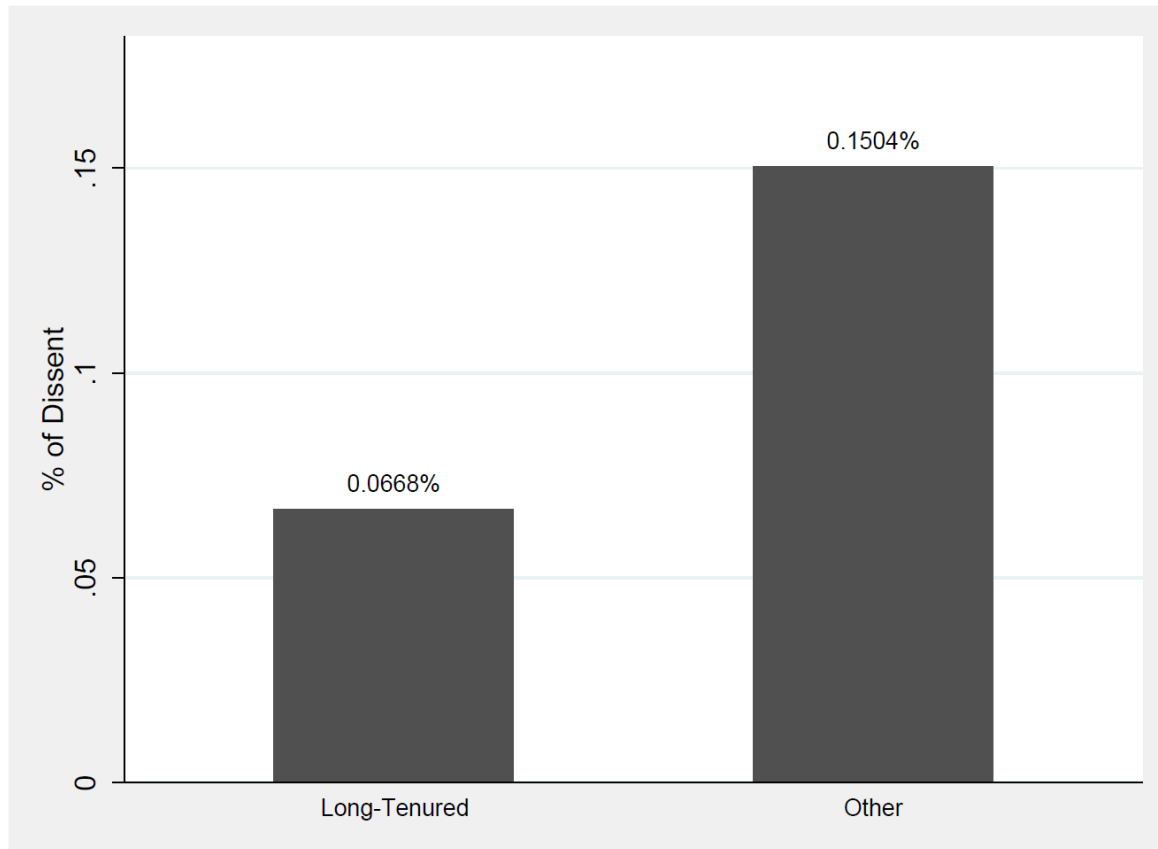
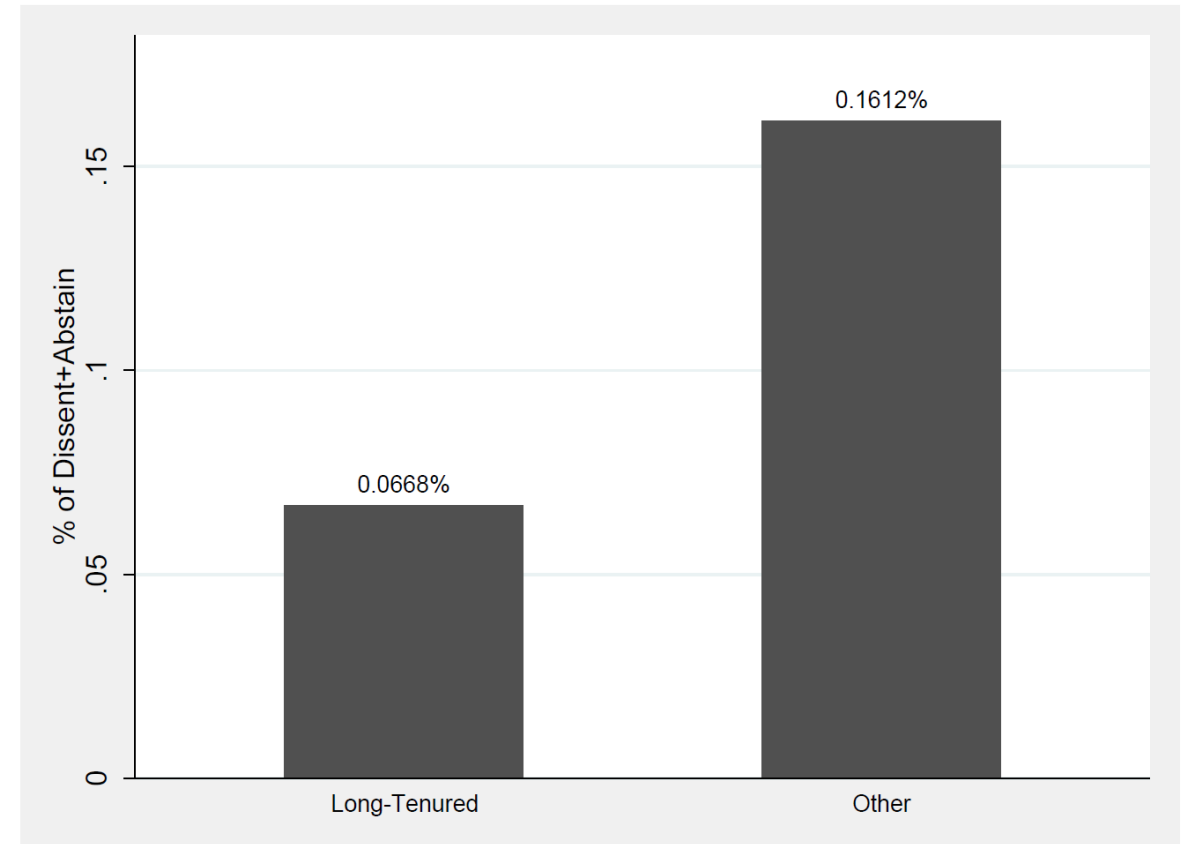


Figure 1-2. Average *Dissent + Abstain* rates



Voting Decisions

(long-tenured versus other outside directors)

	<i>Dissent</i>	<i>Dissent + Abstain</i>
LTOD	-0.00066* (-1.97)	-0.00074** (-2.41)
Age	-0.00003 (-1.24)	-0.00004 (-1.40)
Female	-0.00153** (-2.45)	-0.00165** (-2.48)
Professor	0.00014 (0.26)	0.00008 (0.14)
MBA	-0.0014 (-0.24)	-0.00019 (-0.34)
Attorney	-0.00041 (-0.59)	-0.00028 (-0.35)
Accountant	-0.00082 (-1.68)	-0.00091 (-1.86)
Board Characteristics	Yes	Yes
Firm-level Controls	Yes	Yes
Proposal-Type FE	Yes	Yes
Observations	39,435	39,435
Adj. R-squared	0.0020	0.0021

67.3% drop given average [Dissent + Abstain] rate (2018-2021): 0.0011

Voting Decisions

(long-tenured versus newly-elected outside directors)

Figure 2-1. Average *Dissent* rates

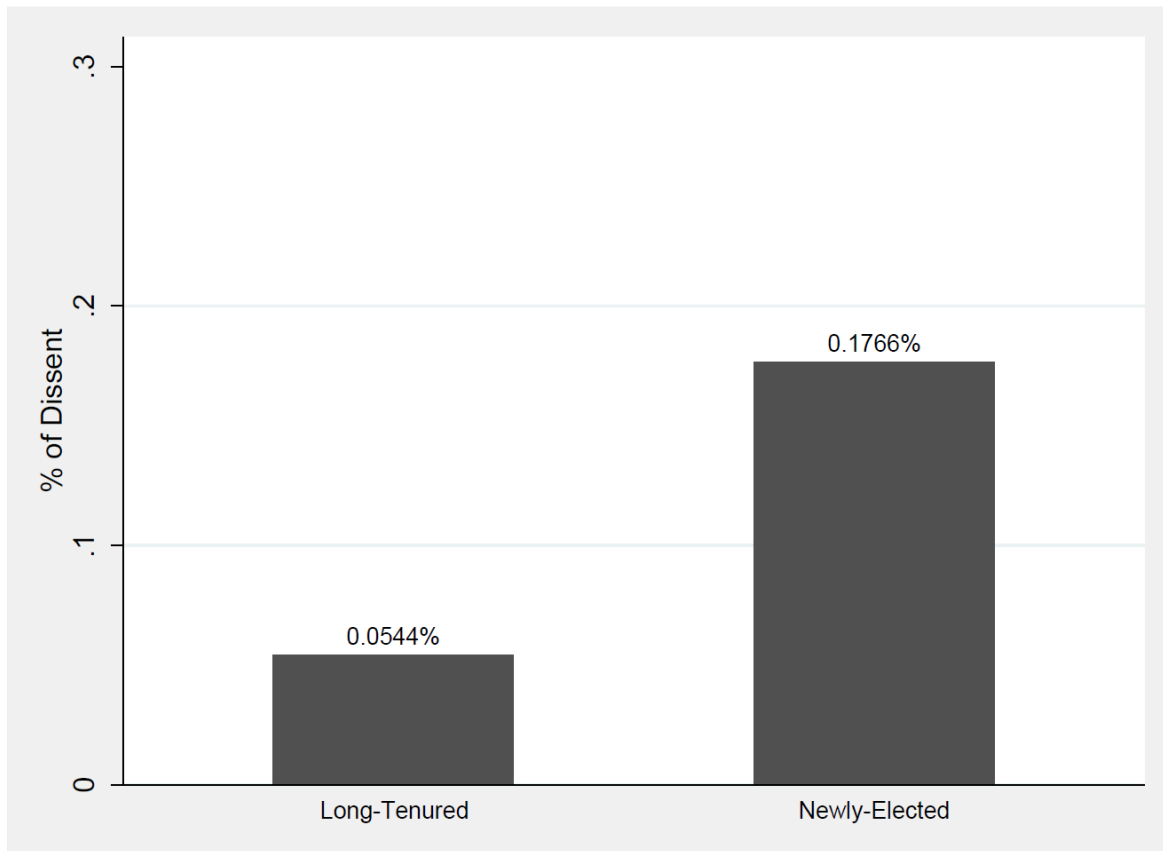
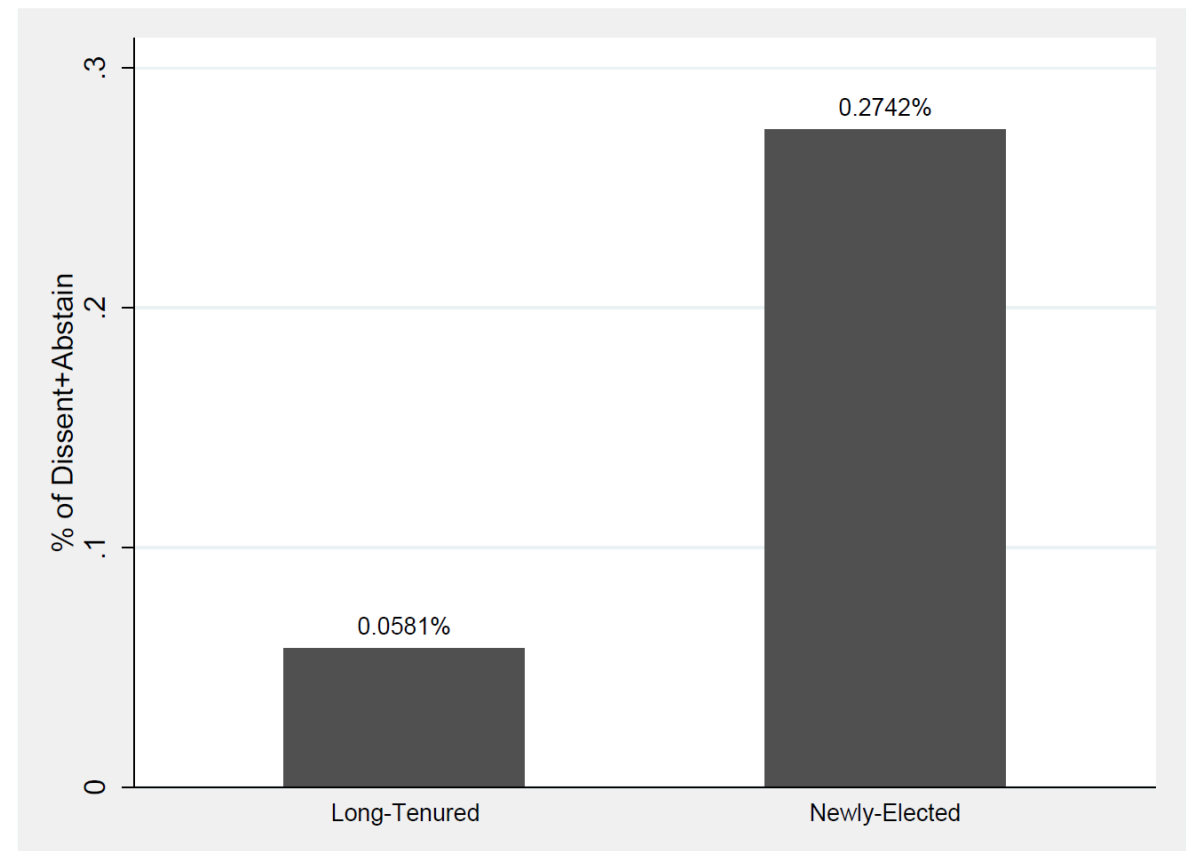


Figure 2-2. Average *Dissent + Abstain* rates



Voting Decisions

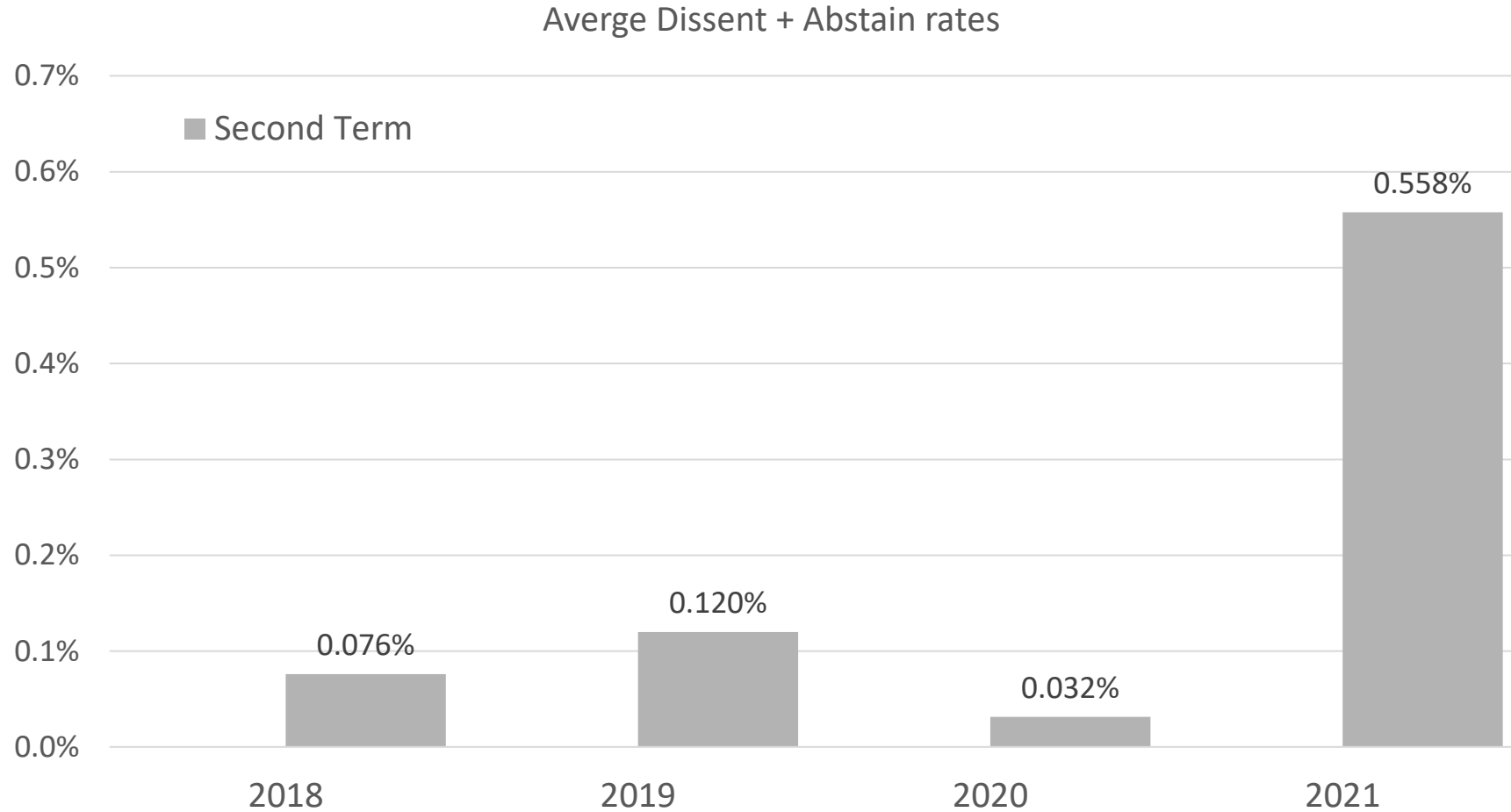
(long-tenured versus newly-elected outside directors)

	<i>Dissent</i>	<i>Dissent + Abstain</i>
LTOD	-0.00115** (-2.50)	-0.00116** (-2.33)
Age	-0.00005* (-1.81)	-0.00005* (-2.07)
Female	-0.00186** (-2.61)	-0.00216** (-2.67)
Professor	0.00017 (0.37)	0.00021 (0.43)
MBA	0.00023 (0.21)	0.00082 (0.73)
Attorney	-0.00053 (-0.73)	-0.00030 (-0.39)
Accountant	-0.00130** (-2.28)	-0.00149** (-2.34)
Board Characteristics	Yes	Yes
Firm-level Controls	Yes	Yes
Proposal-Type FE	Yes	Yes
Observations	25,421	25,421
Adj. R-squared	0.0022	0.0022

63.7% drop given average [Dissent + Abstain] rate (2018-2021): 0.00182

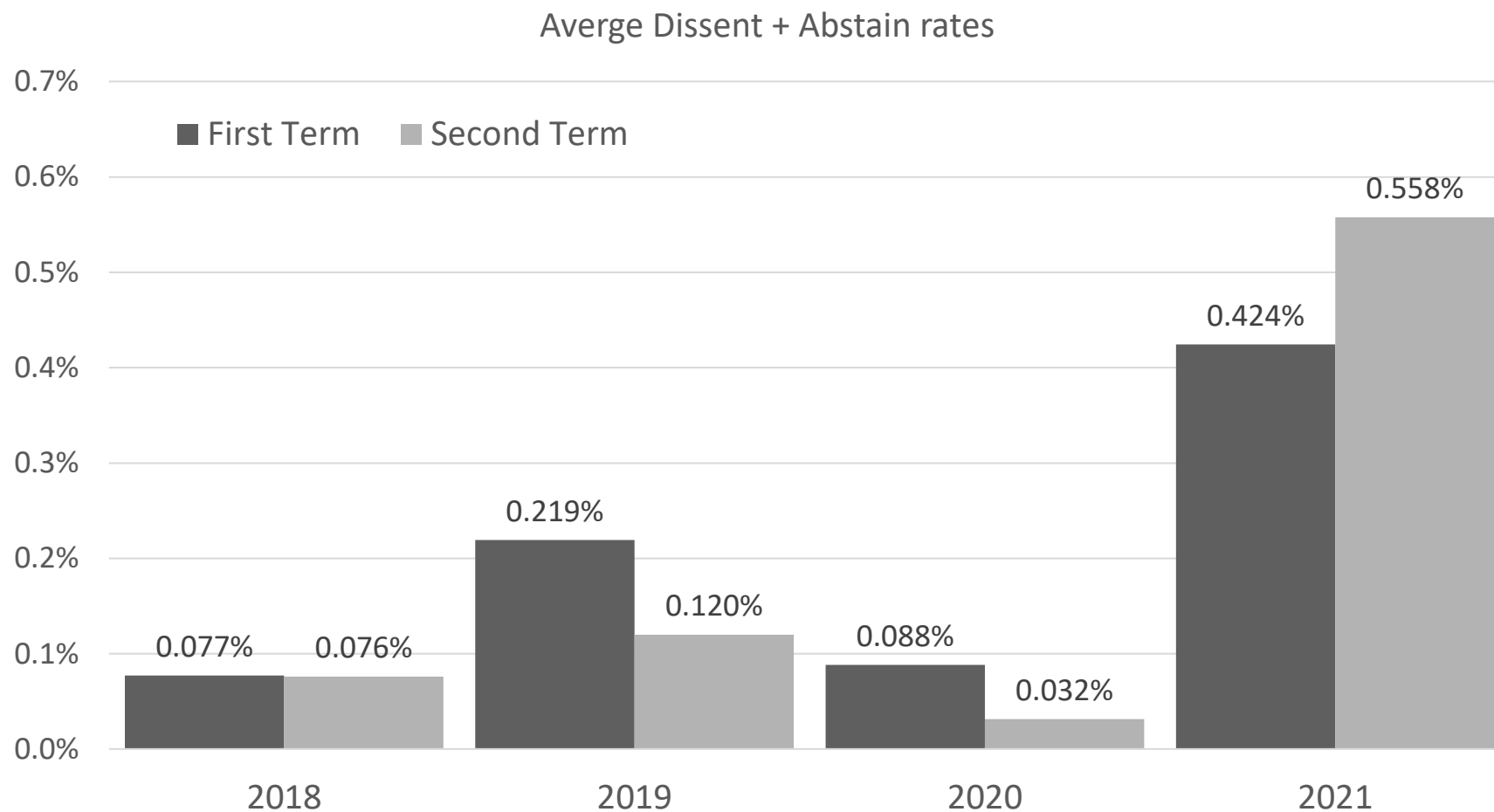
Voting Decisions (bar graph)

(first versus second-term outside directors)



Voting Decisions (bar graph)

(first versus second-term outside directors)



Voting Decisions (Dynamic DiD)

(first versus second-term outside directors)

	<i>Dissent</i>	<i>Dissent + Abstain</i>
Second Term \times Year ²⁰¹⁸	0.00092 (0.90)	0.00102 (0.98)
Second Term \times Year ²⁰²⁰	0.00025 (0.29)	-0.00025 (-0.27)
Second Term \times Year ²⁰²¹	0.00061 (0.43)	0.00046 (0.30)
Director-level Controls	Yes	Yes
Board Characteristics	Yes	Yes
Firm-level Controls	Yes	Yes
Firm FE	Yes	Yes
Proposal-Type FE	Yes	Yes
Observations	60,560	60,560
Adj. R-squared	0.0102	0.0177

Contributions to the Literature

- First paper to examine the impact of a **rule limiting the tenure** of outside directors on **firm valuation** and the **voting decisions of LOTDs and their successors**
 - **Existing literature:** (1) impact of tenure limit rule on the voting decisions of second-term outside directors; (2) relationship between board tenure and firm value
- Establish a **causal relationship** between outside director tenure and firm value